

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF ALLEGIANCE TELECOM

The information required by this Item 10 regarding our directors and executive officers is incorporated in this report by reference from certain sections of our definitive proxy statement for the annual meeting of stockholders for the fiscal year ended December 31, 2002, which will be filed with the SEC no later than April 30, 2003 (the "proxy statement"). You will find our response to this Item 10 in the sections titled "Who Are Allegiance Telecom's Directors, Executive Officers and other Senior Vice Presidents?", "About the Board of Directors and its Committees" and "Section 16(a) Beneficial Ownership Reporting Compliance" of our proxy statement.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item 11 is incorporated in this report by reference from the sections titled "Executive Compensation", "Compensation Committee Interlocks and Insider Participation" and "Compensation of Directors" of our proxy statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item 12 is incorporated in this report by reference from the sections titled "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Information" of our proxy statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item 13 is incorporated in this report by reference from the section titled "Certain Relationships and Related Transactions" of our proxy statement.

ITEM 14. CONTROLS AND PROCEDURES

Within the 90 days prior to the date of this report, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the company required to be included in our periodic SEC filings. There have been no significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation. We have not identified any significant deficiencies or material weaknesses in our internal controls, and therefore there were no corrective actions taken.

The company's management, including the CEO and CFO, does not expect that our disclosure controls or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

- (a)(1) Financial Statements (located on pages F-1 through F-26 of this report)
 - Independent Auditors' Report
 - Report of Independent Public Accountants
 - Consolidated Balance Sheets as of December 31, 2002 and 2001
 - Consolidated Statements of Operations for the years ended December 31, 2002, 2001 and 2000
 - Consolidated Statements of Stockholders' Equity for the years ended December 31, 2002, 2001 and 2000
 - Consolidated Statements of Cash Flows for the years ended December 31, 2002, 2001 and 2000
 - Notes to Consolidated Financial Statements
- (a)(2) Financial Statement Schedules
 - *Report of Independent Public Accountants on Financial Statement Schedule* is located on page S-1 of this report
 - *Valuation and Qualifying Accounts* for the years ended December 31, 2002, 2001 and 2000 is located on page S-2 of this report
- (a)(3) The exhibits filed in response to Item 601 of Regulation S-K are listed in the Exhibit Index starting on page E-1 of this report
- (b) Reports on Form 8-K
 - Allegiance Telecom, Inc. filed a Form 8-K on November 27, 2002, which reported under Item 5 an amendment to its Credit and Guaranty Agreement and the issuance of a press release relating to that amendment

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange act of 1934, Allegiance Telecom, Inc has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on March 31, 2003

ALLEGIANCE TELECOM, INC

BY /s/ ROYCE J HOLLAND,
Royce J Holland,
Chairman of the Board and
Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Mark B Tresnowski and Annie S Terry, and each of them, each with full power to act without the other, his true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for such person and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto each of said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully as to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that each of said attorneys-in-fact and agents, or his or her substitutes, may lawfully do or cause to be done by virtue hereof

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of Allegiance Telecom, Inc and in the capacities indicated on March 31, 2003

SIGNATURE	CAPACITY
<u>/s/ ROYCE J HOLLAND</u> Royce J Holland	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
<u>/s/ C DANIEL YOST</u> C Daniel Yost	President, Chief Operating Officer and Director
<u>/s/ THOMAS M LORD</u> Thomas M Lord	Executive Vice President, Chief Financial Officer and Director (Principal Financial Officer)
<u>/s/ G CLAY MYERS</u> G Clay Myers	Senior Vice President of Finance and Accounting (Principal Accounting Officer)

<u>/s/ ANTHONY J PARELLA</u> Anthony J Parella	President, Telecom and Retail Services and Director
<u>/s/ JAMES E CRAWFORD, III</u> James E Crawford, III	Director
<u>/s/ PAUL J FINNEGAN</u> Paul J Finnegan	Director
<u>/s/ JACOB J GOLDBERG</u> Jacob J Goldberg	Director
<u>/s/ REED E HUNDT</u> Reed E Hundt	Director
<u>/s/ ANDREW D LIPMAN</u> Andrew D Lipman	Director
<u>/s/ JAMES N PERRY, JR</u> James N Perry, Jr	Director

CERTIFICATION

I, Royce J Holland, certify that

1 I have reviewed this annual report on Form 10-K of Allegiance Telecom, Inc ,

2 Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report,

3 Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report,

4 The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared,

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"), and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date,

5 The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function)

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls, and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls, and

6 The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses

Date March 31, 2003

/s/ ROYCE J HOLLAND

Royce J Holland, *Chairman and Chief Executive Officer*

CERTIFICATION

I, Thomas M Lord, certify that

1 I have reviewed this annual report on Form 10-K of Allegiance Telecom, Inc ,

2 Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report,

3 Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report,

4 The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared,

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"), and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date,

5 The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function)

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls, and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls, and

6 The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses

Date March 31, 2003

/s/ THOMAS M LORD

Thomas M Lord, *Executive Vice President of Corporate Development and Chief Financial Officer*

Independent Auditors' Report

The Board of Directors
Allegiance Telecom, Inc

We have audited the consolidated balance sheet of Allegiance Telecom, Inc and subsidiaries as of December 31, 2002, and the related statements of operations, stockholders' equity, and cash flows for the year then ended. In connection with our audit of the consolidated financial statements, we also have audited the financial statement schedule. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audit. The 2001 and 2000 consolidated financial statements and financial statement schedule of the Company as listed in the accompanying index were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those consolidated financial statements and financial statement schedule in their report dated February 19, 2002.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2002 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Allegiance Telecom, Inc and subsidiaries as of December 31, 2002, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related 2002 financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

The accompanying 2002 consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses from operations and is dependant on additional external financing to meet current debt repayment requirements which raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Also, as discussed in Note 4 to the consolidated financial statements, Allegiance Telecom, Inc, in 2002 adopted the provisions of Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets."

KPMG LLP

Dallas, Texas
March 3, 2003

This is a copy of the audit report previously issued by Arthur Andersen LLP in connection with Allegiance Telecom, Inc.'s 2001 consolidated financial statements previously filed on Form 10-K. This audit report has not been reissued by Arthur Andersen LLP in connection with this filing on Form 10-K.

Report of Independent Public Accountants

To the Board of Directors and Stockholders of Allegiance Telecom, Inc

We have audited the accompanying consolidated balance sheets of Allegiance Telecom, Inc. (a Delaware corporation) and subsidiaries (the "Company") as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity and cash flows for the years ended December 31, 2001, 2000, and 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Allegiance Telecom, Inc. and its subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for the years ended December 31, 2001, 2000, and 1999, in conformity with accounting principles generally accepted in the United States.

ARTHUR ANDERSEN LLP

Dallas, Texas
February 19, 2002

ALLEGIANCE TELECOM, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
As of December 31, 2002 and 2001
(in thousands, except share and per share data)

	<u>2002</u>	<u>2001</u>
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$253,311	\$374,084
Short-term investments	30,955	25,232
Accounts receivable (net of allowance for doubtful accounts of \$14,485 and \$29,621, respectively)	153,196	141,684
Prepaid expenses and other current assets	18,916	25,406
Total current assets	456,378	566,406
PROPERTY AND EQUIPMENT		
Property and equipment	1,516,175	1,366,710
Accumulated depreciation	(592,069)	(350,460)
Property and equipment, net	924,106	1,016,250
DEFERRED DEBT ISSUANCE COSTS (net of accumulated amortization of \$15,031 and \$11,870, respectively)	15,879	19,039
LONG-TERM INVESTMENTS, RESTRICTED	881	954
GOODWILL (net of accumulated amortization of \$83,252 as of December 31, 2001)	—	107,468
OTHER ASSETS, net	43,974	64,726
Total assets	<u>\$1,441,218</u>	<u>\$1,774,843</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$59,282	\$50,386
Accrued liabilities and other current liabilities	124,444	85,968
Current portion of long-term debt	561,532	3,120
Total current liabilities	745,258	139,474
LONG-TERM DEBT	639,691	1,013,184
OTHER LONG-TERM LIABILITIES	12,545	14,109
COMMITMENTS AND CONTINGENCIES (see Note 11)		
STOCKHOLDERS' EQUITY		
Preferred stock, \$ 01 par value, 1,000,000 shares authorized, no shares issued or outstanding at December 31, 2002 and 2001	—	—
Common stock, \$ 01 par value, 150,000,000 shares authorized, 125,157,605 and 115,542,354 shares issued and 124,830,110 and 115,214,859 shares outstanding at December 31, 2002 and 2001, respectively	1,251	1,155
Additional paid-in capital	1,808,690	1,801,366
Common stock in treasury, at cost, 327,495 shares at December 31, 2002 and 2001	(45)	(45)
Common stock warrants	1,857	1,877
Deferred compensation	(5,149)	(6,067)
Accumulated deficit	(1,762,880)	(1,190,210)
Total stockholders' equity	43,724	608,076
Total liabilities and stockholders' equity	<u>\$1,441,218</u>	<u>\$1,774,843</u>

The accompanying notes are an integral part of these consolidated financial statements

ALLEGIANCE TELECOM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
For the years ended December 31, 2002, 2001 and 2000
(in thousands, except share and per share data)

	<u>2002</u>	<u>2001</u>	<u>2000</u>
REVENUES	\$770,982	\$516,888	\$285,227
OPERATING EXPENSES			
Network	404,444	251,734	150,718
Selling, general and administrative	438,158	377,387	252,368
Depreciation and amortization	282,143	256,685	130,826
Management ownership allocation charge	—	175	6,480
Non-cash deferred compensation	2,726	4,126	10,127
Goodwill impairment charge	<u>114,722</u>	<u>—</u>	<u>—</u>
Total operating expenses	<u>1,242,193</u>	<u>890,107</u>	<u>550,519</u>
Loss from operations	(471,211)	(373,219)	(265,292)
OTHER INCOME (EXPENSE)			
Interest income	6,594	15,665	56,969
Interest expense	<u>(108,053)</u>	<u>(74,259)</u>	<u>(69,244)</u>
Total other income (expense)	<u>(101,459)</u>	<u>(58,594)</u>	<u>(12,275)</u>
NET LOSS APPLICABLE TO COMMON STOCK	<u><u>\$(572,670)</u></u>	<u><u>\$(431,813)</u></u>	<u><u>\$(277,567)</u></u>
NET LOSS PER SHARE, basic and diluted	<u><u>\$(4.88)</u></u>	<u><u>\$(3.82)</u></u>	<u><u>\$(2.58)</u></u>
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING, basic and diluted	117,349,242	113,115,871	107,773,112

The accompanying notes are an integral part of these consolidated financial statements

ALLEGIANCE TELECOM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the years ended December 31, 2002, 2001 and 2000
(in thousands, except share and per share data)

	Preferred Stock		Common Stock			Treasury Stock		Common Stock Warrants	Deferred Compensation	Deferred Management Ownership Allocation		Accumulated Deficit	Total
	Number of Shares	Amount	Number of Shares	Amount	Additional Paid-In Capital	Number of Shares	Amount			Charge			
Balance, December 31, 1999	—	\$—	97,459,677	\$975	\$940,120	(37,968)	\$ (5)	\$3,719	\$ (13,573)	\$ (6,790)		\$ (480,830)	\$443,616
Issue of stock under the Employee Stock Purchase Plan (see Note 13)	—	—	109,727	1	4,408	—	—	—	—	—		—	4,409
Acquisition of treasury stock	—	—	—	—	—	(289,527)	(40)	—	—	—		—	(40)
Exercise of employee stock options	—	—	700,820	7	4,763	—	—	—	—	—		—	4,770
Stock split	—	—	(577)	—	(52)	—	—	—	—	—		—	(52)
Conversion of common stock warrants	—	—	205,331	2	1,841	—	—	(1,842)	—	—		—	1
Secondary offering of common stock	—	—	10,703,109	107	719,568	—	—	—	—	—		—	719,675
Common stock issued for business acquisitions	—	—	1,214,027	12	44,159	—	—	—	—	—		—	44,171
Common stock options issued for business acquisitions	—	—	—	—	3,852	—	—	—	(957)	—		—	2,895
Deferred compensation	—	—	—	—	11,993	—	—	—	(12,128)	135		—	—
Amortization of deferred compensation	—	—	—	—	—	—	—	—	10,127	6,480		—	16,607
Net loss	—	—	—	—	—	—	—	—	—	—		(277,567)	(277,567)
Balance, December 31, 2000	—	\$—	110,392,114	\$1,104	\$1,730,652	(327,495)	\$ (45)	\$1,877	\$ (16,531)	\$ (175)		\$ (758,397)	\$958,485
Issue of stock under the Employee Stock Purchase Plan (see Note 13)	—	—	672,337	6	4,910	—	—	—	—	—		—	4,916
Exercise of employee stock options	—	—	376,151	4	2,197	—	—	—	—	—		—	2,201
Common stock issued for business acquisitions	—	—	4,101,752	41	69,698	—	—	—	—	—		—	69,739
Deferred compensation	—	—	—	—	(6,213)	—	—	—	6,213	—		—	—
Amortization of deferred compensation	—	—	—	—	—	—	—	—	4,251	175		—	4,426
Other	—	—	—	—	122	—	—	—	—	—		—	122
Net loss	—	—	—	—	—	—	—	—	—	—		(431,813)	(431,813)
Balance, December 31, 2001	—	\$—	115,542,354	\$1,155	\$1,801,366	(327,495)	\$ (45)	\$1,877	\$ (6,067)	\$—		\$ (1,190,210)	\$608,076
Issue of stock under the Employee Stock Purchase Plan (see Note 13)	—	—	2,474,042	25	3,862	—	—	—	—	—		—	3,887
Issue of restricted stock (see Note 13)	—	—	6,495,120	65	(65)	—	—	—	—	—		—	—
Exercise of employee stock options	—	—	85,175	1	22	—	—	—	—	—		—	23
Conversion of common stock warrants	—	—	2,188	—	20	—	—	(20)	—	—		—	—
Common stock issued for business acquisitions	—	—	558,726	5	1,673	—	—	—	—	—		—	1,678
Deferred compensation	—	—	—	—	1,808	—	—	—	(1,808)	—		—	—
Amortization of deferred compensation	—	—	—	—	—	—	—	—	2,726	—		—	2,726
Other	—	—	—	—	4	—	—	—	—	—		—	4
Net loss	—	—	—	—	—	—	—	—	—	—		(572,670)	(572,670)
Balance, December 31, 2002	—	\$—	125,157,605	\$1,251	\$1,808,690	(327,495)	\$ (45)	\$1,857	\$ (5,149)	\$—		\$ (1,762,880)	\$43,724

The accompanying notes are an integral part of these consolidated financial statements

ALLEGIANCE TELECOM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2002, 2001 and 2000
(in thousands, except share and per share data)

	2002	2001	2000
CASH FLOWS FROM OPERATING ACTIVITIES			
Net loss	\$(572,670)	\$(431,813)	\$(277,567)
Adjustments to reconcile net loss to cash used in operating activities—			
Depreciation and amortization	282,143	256,685	130,826
Provision for uncollectible accounts receivable	66,224	41,600	25,914
Accretion of investments	(320)	(2,806)	(5,387)
Accretion of Series B and 12 ⁷ / ₈ % notes	48,567	43,320	38,645
Amortization of deferred debt issuance costs	3,161	4,822	10,293
Amortization of management ownership allocation charge and deferred compensation	2,726	4,301	16,607
Goodwill impairment charge	114,722	—	—
Changes in assets and liabilities, net of effects of acquisitions—			
Increase in accounts receivable	(36,942)	(80,122)	(88,391)
(Increase) decrease in prepaid expenses and other current assets	13,253	(18,836)	(2,283)
Increase in other assets	(14,522)	(10,818)	(690)
Increase (decrease) in accounts payable	3,500	(35,094)	31,429
Increase in accrued liabilities and other current liabilities	21,870	13,125	18,052
Net cash used in operating activities	(68,288)	(215,636)	(102,552)
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchases of property and equipment	(129,896)	(364,396)	(430,817)
Capitalized interest	(6,138)	(16,858)	(14,366)
Purchases of subsidiaries, net of cash acquired	(28,478)	(28,887)	(63,808)
Purchases of investments	(82,532)	(283,926)	(329,884)
Proceeds from sale of investments	77,202	536,183	122,167
Net cash used in investing activities	(169,842)	(157,884)	(716,708)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from borrowings under the credit facilities	135,300	350,000	—
Payment under credit facilities	(15,000)	—	—
Proceeds from issuance of common stock, net	3,910	7,117	728,855
Deferred debt issuance costs	—	(151)	(12,334)
Purchase of treasury stock	—	—	(40)
Payments on capital lease obligations	(6,853)	(5,634)	(3,300)
Other	—	169	(52)
Net cash provided by financing activities	117,357	351,501	713,129
DECREASE IN CASH AND CASH EQUIVALENTS	(120,773)	(22,019)	(106,131)
CASH AND CASH EQUIVALENTS, beginning of period	374,084	396,103	502,234
CASH AND CASH EQUIVALENTS, end of period	<u>\$253,311</u>	<u>\$374,084</u>	<u>\$396,103</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid for interest	59,099	42,250	34,605
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES			
Assets acquired under capital lease obligations	25,032	47,516	14,511
Fair value of assets acquired in business acquisitions	51,319	84,052	38,056
Liabilities assumed in business acquisitions	25,221	28,351	19,074
Common stock issued for business acquisitions (558,726, 4,101,752 and 1,214,027 shares, respectively)	1,678	69,739	44,171
Common stock options issued for business acquisitions (182,324 shares in 2000)	—	—	2,895

The accompanying notes are an integral part of these consolidated financial statements

ALLEGIANCE TELECOM, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2002, 2001 and 2000
(dollars in thousands, except share and per share data)

1. General:

Allegiance Telecom, Inc. is a facilities-based national local exchange carrier that provides integrated telecommunications services to business, government and other institutional users in major metropolitan areas across the United States of America. Allegiance Telecom, Inc. was incorporated on April 22, 1997, as a Delaware corporation, and it and its subsidiaries are generally referred to herein as the "Company."

The Company offers services in 36 of the largest metropolitan areas in the United States of America as follows: Atlanta, Austin, Baltimore, Boston, Chicago, Cleveland, Dallas, Denver, Detroit, Fort Lauderdale, Fort Worth, Houston, Long Island, Los Angeles, Miami, Minneapolis/St. Paul, New York City, Northern New Jersey, Oakland, Ontario/Riverside, Orange County, Philadelphia, Phoenix, Pittsburgh, Portland, Sacramento, St. Louis, San Antonio, San Diego, San Francisco, San Jose, Seattle, Tampa, Washington, D.C., West Palm Beach/Boca Raton and White Plains.

2. Going Concern:

The consolidated financial statements have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. However, as a result of recurring operating losses and debt reduction requirements as stipulated by an interim amendment to the Company's senior secured credit facilities, such realization of assets and satisfaction of liabilities are subject to uncertainty.

The interim amendment requires the Company to reduce total debt to no more than \$645,000 by April 30, 2003 (see Note 7). The Company has been evaluating possible recapitalization transactions and pursuing numerous financial and negotiated strategic alternatives to reduce total indebtedness.

If the Company cannot reduce debt to the required levels by April 30, 2003, it will be in default under the senior secured credit facilities. If any such default occurs, the Company's senior lenders would have the right to request immediate repayment of all senior debt, in which case, the Company's noteholders would then have the right to request immediate repayment of the outstanding notes. If they become immediately due and payable then the Company's bondholders may also accelerate the payment of the Company's bonds under its indentures. If any of these events occur, it would have a material adverse effect and it may result in a foreclosure proceeding or a voluntary or involuntary bankruptcy proceeding. These factors raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Under the terms of the Company's senior secured credit facilities, the Company is required to deliver an unqualified audit report to its senior lenders. As such, if the Company does not receive a waiver from its senior lenders or if it is unable to cure this breach within 30 days, there will be an event of default under the senior secured credit facilities.

3. Summary of Significant Accounting Policies:

Consolidation. The accompanying financial statements include the accounts of Allegiance Telecom, Inc. and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Cash and Cash Equivalents. The Company includes as cash and cash equivalents, cash, marketable securities and commercial paper with maturities of three months or less at the date of purchase

Short-Term Investments. Short-term investments consist primarily of commercial paper with original maturities between three and 12 months at the date of purchase. Such short-term investments are carried at their accreted value, which approximates fair value. Short-term investments are held to maturity and unrealized gains and losses are not significant at December 31, 2002.

Prepaid Expenses and Other Current Assets. Prepaid expenses and other current assets consist of prepaid services, prepaid rent, prepaid insurance and refundable deposits. Prepayments are expensed on a straight-line basis over the corresponding life of the underlying agreements.

Financial Instruments. The carrying value of the Company's cash, short-term investments, accounts receivable and accounts payable approximates their fair value. At December 31, 2002, the Company's 11³/₄% senior discount notes due 2008, 12⁷/₈% senior discount notes due 2008 and senior secured credit facilities were all trading at values below their carrying value. The carrying value of these debt instruments in the Company's consolidated financial statements is significantly higher than their fair value.

Property and Equipment. Property and equipment includes network equipment, land, leasehold improvements, software, office equipment, furniture and fixtures and construction-in-progress. These assets are stated at cost, which includes direct costs and capitalized interest and are depreciated over their respective useful lives using the straight-line method. During the years ended December 31, 2002, 2001 and 2000, \$6,138, \$16,858 and \$14,366, respectively, of interest expense was capitalized related to network construction-in-progress. Repair and maintenance costs are expensed as incurred.

Property and equipment at December 31, 2002 and 2001, consisted of the following:

	2002	2001	Useful Lives (in years)
Network equipment	\$1,148,583	\$869,011	2-20
Land	9,164	9,164	—
Leasehold improvements	145,914	134,618	7-10
Software	125,229	114,553	3
Office equipment and other	46,991	36,824	2-5
Furniture and fixtures	21,334	17,715	7
Property and equipment, in service	1,497,215	1,181,885	
Less: Accumulated depreciation	(592,069)	(350,460)	
Property and equipment, in service, net	905,146	831,425	
Construction-in-progress	18,960	184,825	
Property and equipment, net	<u>\$924,106</u>	<u>\$1,016,250</u>	

Impairment of Long-Lived Assets. The Company reviews the carrying values of property and equipment and intangible assets for impairment whenever current events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment indicators are present, the Company analyzes the projected undiscounted cash flows associated with property and equipment and intangible assets to determine the fair value of these assets. If the assets are determined to be impaired, a loss is recorded in the amount that the carrying value of the assets exceeds their fair value.

The Company performed an analysis comparing estimated future cash flows to the carrying value of its property and equipment and intangible assets at December 31, 2002. This analysis did not indicate that an impairment exists as of December 31, 2002.

Deferred Debt Issuance Costs. Deferred debt issuance costs include costs incurred by the Company in raising debt proceeds. These costs are amortized to interest expense over the life of the related debt.

Goodwill and Other Intangible Assets. Goodwill represents the excess of purchase price over the fair value of net assets of acquired businesses. Goodwill related to businesses acquired prior to June 30, 2001 was amortized on a straight-line basis over an estimated useful life of three years through December 31, 2001. Subsequent to that date, goodwill has not been amortized, but is assessed for impairment at least annually.

The impairment testing is performed at a reporting unit level. The goodwill impairment testing has two steps. The first step identifies potential impairment by comparing the fair value of the reporting unit to its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired and the second step is not necessary. If the carrying value of the reporting unit exceeds its fair value, the second step is performed to calculate the possible impairment loss by comparing the implied fair value of goodwill to the carrying value. If the implied fair value of goodwill is less than the carrying value, a write-down is recorded. The fair value of each reporting unit is determined based on combinations of both the income and market valuation approaches.

Intangible assets are included in other assets and consist primarily of acquired customer lists with definite useful lives. These intangible assets are amortized on a straight-line basis over their estimated useful lives, generally ranging from one to three years.

Restricted Investments. Long-term restricted investments include certificates of deposit held as collateral for letters of credit issued on behalf of the Company.

Revenue Recognition. Revenues for voice, data and other services to end users are recognized in the month in which the service is provided. Amounts invoiced and collected in advance of services provided are recorded as deferred revenue and are recognized as revenue over the period that the services are provided (see Note 6 for amounts of deferred revenue). Revenues for carrier interconnection, access and reciprocal compensation are recognized in the month in which the service is provided, except when realization of these revenues is not reasonably assured. The ability of competitive local exchange carriers (such as the Company) to earn local reciprocal compensation revenues and access revenues is the subject of numerous regulatory and legal challenges. Until these issues are ultimately resolved, the Company's policy is to recognize this revenue only when realization is reasonably assured.

For customer premise equipment contracts, revenue is recognized using the percentage-of-completion method, based on the percentage which incurred contract costs to date bear to total estimated contract costs after giving effect to the most recent estimates of total cost. Risks relating to delivery, usage, productivity and other factors are considered in the estimation process. The effect of changes to total estimated contract revenue and costs is recognized in the period such changes are determined. Provisions for estimated losses on individual contracts are made in the period in which the loss first becomes apparent.

In December 1999, the SEC issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101), which provides additional guidance on revenue recognition as well as criteria for when revenue is realized and earned and related costs are incurred. The Company adopted

SAB 101 on October 1, 2000. The adoption of SAB 101 did not have a material effect on the Company's results of operations.

Network Expenses. Network expense is recognized in the month in which the service is utilized. Accruals for unbilled leased network facilities, network access charges, and equipment colocation charges are based on circuit counts, estimated usage, and active colocation sites. Additionally, accrued network expense includes charges invoiced by carriers which are probable network expenses but have not yet been paid due to rate or volume disputes with other carriers. Network expenses do not include an allocation of depreciation or amortization expense.

Stock Splits. On February 28, 2000, the Company effected a three-for-two stock split in the form of a 50% stock dividend. All references to the number of common shares and per share amounts have been restated to reflect the stock split for all periods presented.

Stock Based Compensation. At December 31, 2002, the Company had three stock-based compensation plans, the 1997 Nonqualified Stock Option Plan, the 1998 Stock Incentive Plan and the Employee Stock Discount Purchase Plan (see Note 13). The Company applies the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25) and the related interpretations in accounting for the Company's plans. Fixed stock option awards with pro-rata vesting are recognized as expense using the straight-line method over the vesting period.

Had compensation cost for the Company's plans been determined based on the fair value of the stock options as of the grant dates for awards under the plans consistent with the method prescribed in Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the Company's net loss applicable to common stock and net loss per share would have increased to the pro forma amounts indicated below. The Company utilized the following assumptions in calculating the estimated fair value of each stock option on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants:

	2002	2001	2000
Dividend yield	—%	—%	—%
Expected volatility	123.0%	115.7%	109.9%
Expected life	3.0	3.7	4.4
Risk-free interest rate	3.32%	4.27%	5.83%

	2002	2001	2000
Reported net loss	\$(572,670)	\$(431,813)	\$(277,567)
Add stock-based employee compensation expense included in reported net income	2,726	4,126	10,127
Deduct stock-based employee compensation expense determined under fair value method for all awards	(178,643)	(212,384)	(129,939)
Pro forma net loss	<u>\$(748,587)</u>	<u>\$(640,071)</u>	<u>\$(397,379)</u>

Net loss per share, basic and diluted—as reported	\$(4.88)	\$(3.82)	\$(2.58)
Net loss per share, basic and diluted—pro forma	\$(6.38)	\$(5.66)	\$(3.69)

Treasury Stock. Treasury stock transactions are accounted for using the cost method.

Loss Per Share. The Company calculates net loss per share under the provisions of Statement of Financial Accounting Standards No. 128, "Earnings per Share."

The securities listed below were not included in the computation of diluted loss per share, as the effect from the conversion would be antidilutive

	2002	2001	2000
Common Stock Warrants ..	205,785	207,973	207,973
1997 Nonqualified Stock Option Plan	475,224	531,196	791,122
1998 Stock Incentive Plan	15,607,460	24,666,776	20,392,248
Employee Stock Discount Purchase Plan	56,839	432,250	82,270

Income Taxes. Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Segment Reporting. The Company operates its business as a single segment, providing integrated telecommunications services. This segment includes all services offered by the Company, including local voice service, long distance service, data services, and customer premise equipment sales and maintenance services. These services have similar network operations and are sold through similar sales channels to the same targeted customer base. The Company manages these services as a single segment and prepares and reviews financial results on this single segment.

Use of Estimates in Financial Statements. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. The Company continually evaluates its estimates, including those related to revenue recognition, accounts receivable, network expenses and impairment of long-lived assets. The Company bases its estimates on historical experience and on other relevant assumptions that are believed to be reasonable under the circumstances. These estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

Recent Accounting Pronouncements. In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations." This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The adoption of this statement did not have a material effect on the financial condition or results of operations of the Company.

In August 2001, the Financial Accounting Standards Board also issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. Adoption of this statement is required for fiscal years beginning after December 15,

2001 The adoption of this statement did not have a material effect on the financial condition or results of operations of the Company

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 146, "Accounting for Costs Associated with Exit or Disposal Activities " This statement addresses financial accounting and reporting for costs associated with exit or disposal activities Adoption of this statement is required for exit or disposal activities initiated after December 31, 2002, with early application encouraged The adoption of this statement is not expected to have a material effect on the financial condition or results of operations of the Company

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 148, "Accounting for Stock Based Compensation-Transition and Disclosure " This statement provides alternative methods of transition to entities that adopt the fair value method of accounting for stock-based employee compensation The statement also requires expanded disclosure of pro-forma fair value stock compensation information for all companies regardless of whether an entity adopts the fair value method of accounting for stock based compensation These disclosures are generally required for fiscal years ending after December 15, 2002 and have been included in the notes to the Company's consolidated financial statements

In November 2002, the Financial Accounting Standards Board's Emerging Issues Task Force reached a consensus on EITF Issue No 00-21, "Revenue Arrangements with Multiple Deliverables " EITF Issue No 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets The provisions of EITF Issue No 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003 The Company does not expect EITF Issue No 00-21 to have a material effect on its financial condition or results of operations

4. Business Combinations:

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 141, "Business Combinations " This statement addresses financial accounting and reporting for business combinations Adoption of this statement is required for all business combinations consummated after June 30, 2001 All of the Company's prior business combinations have been accounted for under the purchase method of accounting Therefore, the adoption of this statement did not have a material impact on the Company's business acquisition model

In June 2001, the Financial Accounting Standards Board also issued Statement of Financial Accounting Standards No 142, "Goodwill and Other Intangible Assets " This statement (1) requires that goodwill balances no longer be amortized but rather assessed for impairment at least annually and (2) expands the classifications of other intangible assets and provides guidance for estimating the expected useful lives of these assets

The table below shows the impact of the amortization recognized in prior years for intangibles that are no longer amortized after the adoption of Statement of Financial Accounting Standards No. 142.

	2002	2001	2000
		(unaudited)	
Reported net loss	\$(572,670)	\$(431,813)	\$(277,567)
Add back: Goodwill amortization	—	55,227	22,279
Add back: Acquired workforce amortization	—	1,181	401
Adjusted net loss	\$(572,670)	\$(375,405)	\$(254,887)
Basic and diluted net loss per share			
Reported net loss per share	\$(4.88)	\$(3.82)	\$(2.58)
Goodwill amortization	—	0.49	0.21
Acquired workforce amortization	—	0.01	—
Adjusted net loss per share	\$(4.88)	\$(3.32)	\$(2.37)

The Company is required to assess the value of goodwill under the provisions of Statement of Financial Accounting Standards No. 142. The Company identified one reporting unit, as defined in Statement of Financial Accounting Standards No. 142. As outlined in the authoritative literature, the assessment of whether goodwill has been impaired is based on the Company's estimate of the fair value of the reporting unit using a model which considers both a discounted future cash flow analysis and market capitalization data. Upon adoption of Statement of Financial Accounting Standards No. 142 on January 1, 2002, there was no indication of an impairment in the Company's goodwill intangible.

During the six months ended June 30, 2002, the market capitalization of the Company remained at a level well below its book value. As this decline in the market capitalization indicates that a potential impairment in the value of goodwill exists, management performed an interim valuation as of June 30, 2002 using a valuation model which considers both a discounted future cash flow analysis and market capitalization data. A final valuation was performed by an independent valuation services company. This valuation indicated that an impairment of goodwill existed as of June 30, 2002. Accordingly, the Company recorded a charge of \$114,722 during 2002, reflecting the amount of impairment as of June 30, 2002 to eliminate the enterprise goodwill intangible.

The changes in the carrying value of goodwill during the year ended December 31, 2002 are as follows:

Balance as of December 31, 2001	\$107,468
Reclassification of acquired workforce	1,731
Final purchase price adjustments	5,523
Impairment charge	(114,722)
Balance at December 31, 2002	\$—

Business Acquisitions

On June 17, 2002, the Company purchased substantially all of the assets of WorldCom's customer premise equipment sales and WorldCom's customer premise equipment maintenance businesses, known in the industry as "Shared Technologies Fairchild" or "Shared Technologies." The Company acquired these businesses for a cash purchase price of \$30,000 and assumption of specified liabilities. The excess of purchase price over the fair value of the net assets acquired was recorded as goodwill of \$3,902. The

acquisition was accounted for using the purchase method, and accordingly, the net assets and results of operations of Shared Technologies have been included in the Company's consolidated financial statements since the date of acquisition. Included in the Company's financial statements were \$78,705 of revenues and \$47,853 of network expenses related to the Shared Technologies businesses for the year ended December 31, 2002.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed related to the Shared Technologies business:

Current assets	\$46,494
Property and equipment	4,733
Other Assets	92
Goodwill	<u>3,902</u>
Total assets acquired	55,221
Current liabilities	<u>25,221</u>
Total liabilities assumed	<u>25,221</u>
Net assets acquired	<u>\$30,000</u>

The following presents the unaudited pro forma results of the Company for the years ended December 31, 2002, 2001 and 2000, as if the acquisition of the Shared Technologies businesses had been consummated at the beginning of each of the periods presented. The pro forma results are prepared for comparative purposes only and do not necessarily reflect the results that would have occurred had the acquisitions occurred at the beginning of the periods presented or the results which may occur in the future.

	2002	2001
	(unaudited)	
Revenue	\$849,081	\$645,312
Net loss	(571,274)	(498,147)
Net loss per share, basic and diluted	(4.87)	(4.40)

Additionally, during the year ended December 31, 2002, the Company paid contingent consideration totaling \$1,928, consisting of \$250 in cash and 558,726 shares of its common stock as provided in the merger agreements with Jump Net, Inc. (acquired in 2000) and Coast to Coast Telecommunications, Inc. (acquired in 2001). The consideration paid during 2002 was included in accrued liabilities at December 31, 2001. There is no additional consideration payable under any of the Company's acquisition agreements.

During the year ended December 31, 2001, the Company paid contingent consideration totaling \$17,858, consisting of \$13,988 in cash, of which \$2,362 was included in accrued liabilities at December 31, 2000, and 407,250 shares of the Company's common stock as provided in the merger agreements with the following businesses acquired during 2001 and 2000: InterAccess Co., Virtualis Systems, Inc., Jump Net, Inc., CTSnet and Adgrafix Corporation. There is no additional consideration payable under these acquisition agreements.

During the year ended December 31, 2001, the Company acquired the stock of Adgrafix Corporation, an Internet-based, web hosting applications specialist, and Coast to Coast Telecommunications, Inc., a provider of local and long-distance telecommunications services. The Company also acquired certain assets of HarvardNet, Inc., an Internet-based, web hosting applications

specialist, and Intermedia Business Internet, a Tier 1 Internet service provider. The Company acquired these entities for an aggregate purchase price of \$92,602, consisting of \$17,651 in cash and 3,694,502 shares of the Company's common stock. The excess of purchase price over the fair value of the net assets acquired was recorded as goodwill of \$34,896.

During the year ended December 31, 2000, the Company acquired the following four regional Internet service providers: CONNECTnet Internet Network Services, InterAccess Co., CTSnet, a division of Datel Systems Incorporated, and Jump Net, Inc. In addition, during 2000, the Company acquired Virtualis Systems, Inc., an Internet-based, web hosting applications specialist.

In connection with its integration plan for the acquired businesses, the Company recorded additional goodwill to establish reserves for certain costs, including the termination of acquired redundant network elements, closure of acquired duplicate facilities, and severance of certain employees. If the Company does not utilize the full extent of the established reserves for their intended purposes, the reserves will be reversed and will be included as an extraordinary item in the Company's consolidated financial statements since goodwill has been fully impaired.

Each of the acquisitions discussed above were accounted for using the purchase method of accounting. Accordingly, the net assets and results of operations of the acquired companies have been included in the Company's consolidated financial statements since the acquisition dates. The purchase price of the acquisitions was allocated to assets acquired, including identified intangible assets, and liabilities assumed, based on their respective estimated fair values at acquisition. The Company's purchase price allocation of the acquisition made in 2002 is preliminary, subject to post-acquisition due diligence of the acquired entity, and may be adjusted as additional information is obtained. During the years ended December 31, 2002 and 2001, immaterial adjustments were made to the purchase price allocation of the entities acquired in 2001 and 2000.

5. Other Assets:

Other assets consisted of the following:

	2002	2001
Acquired customer lists	\$62,800	\$62,800
Acquired workforce intangibles	—	3,348
Long-term deposits	17,030	4,040
Equipment pending deployment	8,688	6,827
Other	5,645	6,231
Total other assets	94,163	83,246
Less: Accumulated amortization	(50,189)	(18,520)
Other assets, net	\$43,974	\$64,726

On January 1, 2002, the Company reclassified the value of the acquired workforce intangibles and related accumulated amortization to goodwill in accordance with Statement of Financial Accounting Standards No. 142 (See Note 4).

The acquired intangibles are being amortized over their estimated useful lives of one to three years using the straight-line method. Amortization expense related to intangible assets totaled \$33,386.

and \$13,235 during the years ended December 31, 2002 and 2001, respectively. The estimated aggregate future amortization expense for intangible assets remaining as of December 31, 2002 is as follows:

2003	\$10,301
2004	2,310
Total	<u>\$12,611</u>

Long-term deposits include a \$10,800 prepayment to AT&T for long-distance services. Equipment pending deployment consists of equipment purchased and being staged for deployment in the Company's network. This equipment will be classified as property and equipment when it is deployed.

6. Accrued Liabilities and Other Current Liabilities:

Accrued liabilities and other current liabilities consisted of the following:

	2002	2001
Accrued employee compensation and benefits	\$11,824	\$10,314
Accrued network expenses	52,643	40,313
Business acquisition costs	10,502	15,657
Accrued taxes	10,051	8,171
Accrued interest expense	4,154	4,103
Deferred revenue	29,009	3,088
Other	6,261	4,322
Accrued liabilities and other current liabilities	<u>\$124,444</u>	<u>\$85,968</u>

Business acquisition costs primarily included reserves for termination of acquired redundant network elements and closure of acquired duplicate facilities (See Note 4).

7. Long-Term Debt:

Long-term debt consisted of the following:

	2002	2001
Series B 11 ³ / ₄ % notes, face amount \$445,000 due February 15, 2008, effective interest rate of 12.21%, at accreted value	\$433,974	\$385,765
12 ⁷ / ₈ % senior notes, face amount \$205,000 due May 15, 2008, effective interest rate of 13.24%, at accreted value	202,210	201,852
Senior secured credit facilities, variable interest rate	470,300	350,000
Capital lease obligations (see Note 8)	94,739	78,687
Total debt	1,201,223	1,016,304
Less: current portion of long-term debt	561,532	3,120
Long-term debt	<u>\$639,691</u>	<u>\$1,013,184</u>

The approximate annual debt maturities for the five years subsequent to December 31, 2002, are as follows

2003	\$556,223
2004	82,060
2005	145,590
2006	242,650
2007	—
Thereafter	93,777
Total	<u>\$1,120,300</u>

2003 long-term debt maturities include a reduction in debt as required by the Company's interim agreement with its senior bank creditors, as discussed below

Series B 11³/₄% Notes Due 2008. On February 3, 1998, the Company raised gross proceeds of approximately \$250,477 in an offering of 445,000 units, each of which consists of one 11³/₄% senior discount note due 2008 of the Company and one redeemable warrant to purchase approximately 2.19 shares of common stock at an exercise price of \$.01 per share, subject to certain antidilution provisions. Of the gross proceeds, \$242,294 was allocated to the 11³/₄% notes and \$8,184 was allocated to the redeemable warrants. The redeemable warrants became exercisable in connection with the Company's initial public offering (see Note 9) in July 1998.

A registration statement on Form S-4 (File No. 333-49013) registering the 11³/₄% notes, and offering to exchange any and all of the outstanding 11³/₄% notes for Series B 11³/₄% notes due 2008, was declared effective by the Securities and Exchange Commission on May 22, 1998. This exchange offer terminated on June 23, 1998, after substantially all of the outstanding 11³/₄% notes were exchanged. The terms and conditions of the Series B notes are identical to those of the 11³/₄% notes in all material respects.

The Series B notes have a principal amount at maturity of \$445,000 and an effective interest rate of 12.21%. The Series B notes are unsecured and mature on February 15, 2008. Commencing August 15, 2003, interest on such notes is payable in cash at the rate of 11³/₄% per annum on February 15 and August 15 of each year. From and after February 15, 2003, interest on the Series B notes will be payable semi-annually in cash at the rate of 11³/₄% per annum. The Company is required to make an offer to purchase the redeemable warrants for cash at the relevant value upon the occurrence of a repurchase event, as defined in the applicable warrant agreement.

Through March 31, 1999, the Company was recognizing the potential future redemption value of the redeemable warrants by recording accretion of the redeemable warrants to their estimated fair market value at February 3, 2008, using the effective interest method.

Effective April 1, 1999, the Company determined that accreting the redeemable warrants to a future potential redemption value was no longer applicable, as the redemption of the redeemable warrants for cash is no longer beyond the control of the Company, and the redemption date and amount are not reasonably determinable. Accordingly, the accreted value of the redeemable warrants at April 1, 1999, was reclassified to stockholders' equity as common stock warrants, and no further accretion will be recorded. If a repurchase event occurs in the future or becomes probable, the Company will adjust the warrants to the estimated redemption value at that time.

Under the terms of the Series B notes, the Company may redeem these notes at certain times and in certain amounts. Upon a change of control, as defined, the Company is required to make an offer to

purchase the 11³/₄% notes at a purchase price of 101% of the accreted value thereof together with accrued interest, if any

12⁷/₈% Senior Notes Due 2008. On July 7, 1998, the Company raised approximately \$200,919 of gross proceeds from the sale of its 12⁷/₈% senior discount notes due 2008 of which approximately \$69,033 was used to purchase U S government securities, which were placed in a pledged account to secure and fund the first six scheduled payments of interest on the notes.

The 12⁷/₈% notes have a principal amount at maturity of \$205,000 and an effective interest rate of 13.24%. The 12⁷/₈% notes are unsecured and mature on May 15, 2008. Interest on the 12⁷/₈% notes is payable semi-annually in cash at the rate of 12⁷/₈% per annum on May 15 and November 15 of each year. As of December 31, 2002 and 2001, the Company has recorded accrued interest associated with the 12⁷/₈% notes of \$3,299 and \$3,299, respectively, which is included in other current liabilities.

Under the terms of the 12⁷/₈% notes, the Company may redeem these notes at certain times and in certain amounts. Upon a change of control, as defined, the Company is required to make an offer to purchase the 12⁷/₈% notes at a purchase price of 101% of the principal amount thereof, together with accrued interest, if any.

The Series B notes and 12⁷/₈% notes contain certain restrictive covenants that, among other things, limit the ability of the Company to incur indebtedness, create liens, engage in sale-leaseback transactions, pay dividends or make distributions in respect to their capital stock, redeem capital stock, make investments or certain other restricted payments, sell assets, issue or sell stock of certain subsidiaries, engage in transactions with stockholders or affiliates or effect a consolidation or merger. The Company was in compliance with all such restrictive covenants at December 31, 2002.

Senior Secured Credit Facilities. In February 2000, the Company closed on \$500,000 of senior secured credit facilities (Credit Facilities). The Credit Facilities consist of a \$350,000 seven-year revolving credit facility and a \$150,000 two-year delayed draw term loan facility. Interest is generally the London Interbank Offered Rate (LIBOR) plus 4.50%. The blended borrowing rate on outstanding borrowings at December 31, 2002 is 5.77% and will remain fixed until June 26, 2003.

The Credit Facilities are secured by (1) the capital stock of Allegiance Telecom Company Worldwide (which stock is owned by the Company's parent holding company, Allegiance Telecom, Inc.) and (2) all of the assets of Allegiance Telecom Company Worldwide, including the capital stock owned by that entity in each of its subsidiaries.

As of December 31, 2002, there were \$324,800 and \$145,500 of borrowings outstanding under the seven-year revolving credit facility and the two-year delayed draw term loan facility, respectively, all of which are classified as long-term debt. The revolving credit facility will be permanently reduced in accordance with its amortization schedule as follows: 20% in 2004 (a pro-rata amount each quarter), 30% in 2005 (a pro-rata amount each quarter) and 50% in 2006 (a pro-rata amount each quarter). Principal amounts of the delayed draw term loan are to be repaid as follows: 20% in 2004 (pro-rata payments to be made quarterly), 30% in 2005 (pro-rata payments to be made quarterly) and 50% in 2006 (pro-rata payments to be made quarterly).

The Credit Facilities carry certain restrictive and financial covenants that, among other things, limit the Company's ability to incur indebtedness, create liens, engage in sale-leaseback transactions, pay dividends or make distributions in respect of capital stock, redeem capital stock, make investments or certain other restricted payments, sell assets, issue or sell stock of certain subsidiaries, engage in transactions with stockholders or affiliates, effect a consolidation or merger and require the Company to maintain certain operating and financial performance measures.

On November 27, 2002, the Company reached an agreement with its senior bank creditors regarding modifications to the Credit Facilities. Under this agreement, the Company obtained a waiver of all existing financial covenants through April 30, 2003 and replaced those covenants during this period with a free cash flow from operations covenant (EBITDA less capital expenditures) and a total leverage covenant. Under this interim amendment, the Company cannot permit its consolidated total debt to exceed at any time (i) \$1,275,000 from November 27, 2002 through April 29, 2003 and (ii) \$645,000 thereafter. Under the terms of the interim amendment, the Company repaid \$15,000 of the Credit Facilities, which was applied to the initial amortization of the facility scheduled to begin in 2004. The Company was in compliance with interim period covenants at December 31, 2002.

A permanent amendment to the Credit Facilities must be in place prior to the April 30, 2003 waiver expiration. In conjunction with the negotiation of this permanent amendment, the Company has been evaluating possible recapitalization transactions and pursuing numerous financial and negotiated strategic alternatives to reduce total indebtedness.

Under the terms of the Credit Facilities, the Company is required to deliver an unqualified audit report to its senior lenders. The Company received an audit report that is modified to express substantial doubt about the Company's ability to continue as a going concern. As such, if the Company does not receive a waiver from its senior lenders or if it is unable to cure this breach within 30 days, there will be an event of default under the Credit Facilities. An event of default under the Credit Facilities could cause all amounts outstanding under the Credit Facilities to become immediately due and payable. If they become immediately due and payable, the Company's bondholders may also accelerate the payment of outstanding amounts due under the Series B notes and the 12⁷/₈% notes. No adjustment that might result from the potential impact of these acceleration events is reflected in the debt maturity table above.

8. Leases:

The Company has entered into various capital lease agreements, with expirations through 2022, covering dedicated optical fiber capacity and certain equipment. Assets and future obligations related to capital leases are included in the accompanying consolidated balance sheet in property and equipment and long-term debt, respectively. Depreciation of assets held under capital leases is included in depreciation and amortization expense.

The Company has entered into various operating lease agreements, with expirations through 2015, for network facilities, office space and equipment. Rent expense on operating leases for the years ended December 31, 2002, 2001 and 2000, was \$34,600, \$31,765 and \$16,950, respectively.

Future minimum lease obligations for all non-cancelable capital and operating lease agreements with initial or remaining terms of one year or more at December 31, 2002 are as follows

Years ending December 31	Capital Leases	Operating Leases
2003	\$14,046	\$30,545
2004	13,456	28,693
2005	12,601	27,533
2006	12,658	25,300
2007	10,353	23,299
Thereafter	108,652	68,322
Total minimum future lease payments	<u>171,766</u>	<u>\$203,692</u>
Amount representing interest	(77,027)	
Present value of minimum lease payments	94,739	
Current portion	(5,309)	
Long-term capital lease obligations	<u>\$89,430</u>	

Certain operating and capital lease agreements contain renewal and purchase options at the end of the initial lease terms

9. Capitalization:

Preferred Stock. In connection with the Company's initial public offering, the Company authorized 1,000,000 shares of preferred stock with a \$ 01 par value. At December 31, 2002 and 2001, no shares of preferred stock were issued and outstanding.

Common Stock. On February 2, 2000, the Company raised \$693,000 of gross proceeds from the sale of the Company's common stock. The Company sold 9,900,000 shares at a price of \$70 per share. Net proceeds from this offering were \$665,562. On February 29, 2000, the underwriters of this offering exercised an option to purchase an additional 803,109 shares of common stock, providing an additional \$56,218 gross proceeds and \$54,113 net proceeds to the Company.

On February 28, 2000, a three-for-two stock split of the Company's common stock was effected in the form of a 50% stock dividend to shareholders of record on February 18, 2000. Par value remained unchanged at \$ 01 per share. All references to the number of common shares and per share amounts have been restated to reflect the stock split for all periods presented.

At December 31, 2002 and 2001, 125,157,605 and 115,542,354 shares were issued and 124,830,110 and 115,214,859 were outstanding, respectively. Of the authorized but unissued common stock, 19,758,718 shares were reserved for issuance upon exercise of stock options issued under the Company's stock option, stock incentive and stock purchase plans (see Note 13) and 205,851 shares were reserved for issuance, sale and delivery upon the exercise of warrants (see Note 7) at December 31, 2002.

Warrants. During 2002, 1,000 warrants, formerly referred to as redeemable warrants (see Note 7), were exercised to purchase 2,188 shares of common stock. Fractional shares are not issued, cash payments are made in lieu thereof, according to the terms of the warrant agreement. No warrants were exercised during 2001. At December 31, 2002 and 2001, 94,031 and 95,031 warrants, respectively, were outstanding. The warrants will expire on February 3, 2008.

Deferred Compensation. During 1998 and 1997, certain management investors acquired membership units of Allegiance Telecom, LLC at amounts less than the estimated fair market value of the membership units, consequently, the Company recognized deferred compensation of \$10,090 and \$978 at December 31, 1998 and 1997, respectively, of which \$41, \$2,726 and \$2,767 was amortized to expense during the periods ended December 31, 2002, 2001 and 2000, respectively. In connection with the initial public offering, the redeemable preferred stock was converted into common stock and Allegiance Telecom, LLC was dissolved. The deferred compensation charge is amortized based upon the period over which the Company has the right to repurchase certain of the securities (at the lower of fair market value or the price paid by the employee) in the event the management investor's employment with the Company is terminated. Deferred compensation also includes stock options granted at an exercise price less than market value, stock options subject to variable plan accounting, and restricted stock issued to management employees (see Note 13).

Deferred Management Ownership Allocation Charge. On July 7, 1998, in connection with the initial public offering, certain venture capital investors and certain management investors owned 95.0% and 5.0%, respectively, of the ownership interests of Allegiance Telecom, LLC, which owned substantially all of the Company's outstanding capital stock. As a result of the successful initial public offering, Allegiance Telecom, LLC was dissolved and its assets (which consisted almost entirely of such capital stock) were distributed to the venture capital investors and management investors in accordance with the Allegiance Telecom, LLC's limited liability company agreement. This agreement provided that the equity allocation between the venture capital investors and the management investors be 66.7% and 33.3%, respectively, based upon the valuation implied by the initial public offering. The Company recorded the increase in the value of the assets of Allegiance Telecom, LLC allocated to the management investors as a \$193,537 increase in additional paid-in capital, of which \$122,476 was recorded as a noncash, nonrecurring charge to operating expenses and \$71,061 was recorded as a deferred management ownership allocation charge. The deferred charge was amortized at \$175 and \$6,480 as of December 31, 2001 and 2000, and was fully amortized as of March 31, 2001. The Company repurchased 289,527 shares from terminated management investors during 2000. A remaining deferred charge of \$135 related to these shares was reversed to additional paid-in capital upon the repurchase of the shares.

10. Related Parties:

During 2002, the Company incurred approximately \$450 in legal fees to a law firm in which a member of the Company's board of directors is a senior partner.

During 2001, the Company loaned \$4,200 to a director and executive vice president of the Company under a full recourse promissory note. The note is payable in full on April 4, 2004. The outstanding balance accrues interest at 2.73% per annum, which was the November 2001 applicable federal rate, and interest is payable when this note is due. In the event the executive resigns or is terminated by Allegiance for cause, this note will become immediately due and payable. The note is included in other long-term assets in the accompanying consolidated balance sheet.

During 2001, the Company incurred \$351 in charges for company business travel on an airplane owned and operated by a company that is wholly-owned by a director and executive vice president of the Company. The air travel rate charged for use of the airplane was at least as favorable as the rate charged by private aircraft owners unaffiliated with the Company. No such payments were made during 2002.

11. Commitments and Contingencies:

In April 2000, the Company executed a master procurement agreement with Lucent Technologies Inc for a broad range of advanced telecommunications equipment, software and services. This agreement contains a three-year \$350,000 purchase commitment. In July 2001, this agreement was amended to extend the term to six years. Under the amended agreement, the Company must complete purchases totaling \$100,000 by December 31, 2000, an aggregate of \$160,000 of purchases by September 30, 2001, an aggregate of \$210,000 by December 31, 2002, an aggregate of \$257,000 by December 31, 2003, an aggregate of \$304,000 by December 31, 2004, and the full \$350,000 of aggregate purchases on or before December 31, 2005. In 2002, Lucent waived \$50,000 of the \$210,000 purchase commitment for 2002 in exchange for a purchase commitment by the Company of approximately \$13,100 of telecommunications equipment.

The Company purchased the \$13,100 of telecommunications equipment and has satisfied the purchase commitment for 2002. As of December 31, 2002, the remaining commitment under this agreement is approximately \$123,800. The agreement provides that, subject to certain conditions, if the Company does not meet the required purchase milestones, the Company will be required to provide cash settlement in an amount equal to the shortfall. During the term of the contract, such shortfall payments may be applied to future purchases in the next succeeding year. Given the change in focus in the Company's business to achieving profitability, the Company is in the process of renegotiating this contract with Lucent. There can be no assurance that the Company will be successful in completing the renegotiation.

12. Federal Income Taxes:

The Company accounts for income tax under the provisions of Statement of Financial Accounting Standards No 109, "Accounting for Income Taxes" (SFAS 109). SFAS 109 requires an asset and liability approach which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events which have been recognized in the Company's financial statements. The Company had approximately \$1,344,311 and \$877,794 of net operating loss carryforwards for federal income tax purposes at December 31, 2002 and 2001, respectively. The net operating loss carryforwards will begin to expire in the years 2012 through 2019 if not previously utilized. The Company has recorded a valuation allowance equal to the net deferred tax assets at December 31, 2002 and 2001, due to the uncertainty of future operating results. The valuation allowance will be reduced at such time as management is able to determine that the realization of the deferred tax assets is more likely than not to occur. Generally, reductions in the valuation allowance will reduce future provisions for income tax expense. Reductions in the valuation allowance related to tax deductions for employee stock option exercises will reduce the Company's additional paid-in capital.

The tax effects of temporary differences that give rise to deferred tax assets and deferred tax liabilities at December 31, 2002 and 2001 are presented below

	2002	2001
Deferred tax assets		
Net operating loss carryforward	\$539,357	\$327,417
Start-up costs capitalized for tax purposes	643	1,069
Amortization of intangibles	16,287	—
Allowance for doubtful accounts	6,327	15,797
Accrued liabilities and other	6,557	21,975
Amortization of original issue discount	71,109	51,906
Total gross deferred tax assets	640,280	418,164
Less valuation allowance	(556,959)	(342,394)
Net deferred tax assets	\$83,321	\$75,770
Deferred tax liabilities		
Depreciation	\$(83,321)	\$(71,919)
Amortization of intangibles	—	(3,851)
Total gross deferred tax liabilities	(83,321)	(75,770)
Net deferred tax asset	\$—	\$—

Amortization of the original issue discount on the Series B notes and the 12⁷/₈% notes as interest expense is not deductible in the income tax return until paid. Amortization of goodwill created in a stock acquisition is not deductible in the Company's income tax return; therefore, the effective income tax rate differs from the statutory rate.

Under existing income tax law, all operating expenses incurred prior to commencing principal operations and expansion into new markets are capitalized and amortized over a five-year period for tax purposes.

A reconciliation of the Company's effective tax rate and the U S federal and state tax rate is as follows:

	2002
Statutory U S federal rate	(35)%
State income taxes, net of federal benefit	(3)%
Valuation allowance for deferred taxes	32%
Goodwill and other identifiable intangibles	6%
	—%

13. Stock Option/Stock Incentive/Stock Purchase Plans:

1997 Nonqualified Stock Option Plan And 1998 Stock Incentive Plan. Under the 1997 stock option plan, the Company granted stock options to key employees, a director and a consultant of the Company for an aggregate of 1,580,321 shares of common stock. The Company will not grant stock options for any additional shares under the 1997 stock option plan.

Under the 1998 stock incentive plan, the Company may grant stock options to certain employees, directors, advisors and consultants of the Company. The 1998 stock incentive plan provides for issuance of the following types of incentive awards: stock options, stock appreciation rights, restricted stock, performance grants and other types of awards that the Compensation Committee of the Board of Directors deems consistent with the purposes of the 1998 stock incentive plan. The Company has 18,857,402 shares of common stock reserved for issuance under the 1998 stock incentive plan at December 31, 2002.

Stock options granted under both plans generally have a term of six years and vest over a three-year period and the Compensation Committee of the Board of Directors administers both option plans.

A summary of the status of the 1997 stock option plan as of December 31, 2002, 2001 and 2000 is presented in the table below.

	<u>December 31, 2002</u>		<u>December 31, 2001</u>		<u>December 31, 2000</u>	
	Weighted Average		Weighted Average		Weighted Average	
	<u>Shares</u>	<u>Exercise Price</u>	<u>Shares</u>	<u>Exercise Price</u>	<u>Shares</u>	<u>Exercise Price</u>
Outstanding, beginning of period	531,196	\$1.80	745,172	\$1.80	1,098,155	\$1.79
Granted	—	—	—	—	—	—
Exercised	(8,532)	1.65	(213,300)	1.80	(334,216)	1.76
Forfeited	(47,440)	1.69	(676)	2.27	(18,767)	1.88
Outstanding, end of period	<u>475,224</u>	1.82	<u>531,196</u>	1.80	<u>745,172</u>	1.80
Options exercisable at period-end	475,224		531,196		595,660	

The following table sets forth the range of exercise prices and weighted average remaining contractual life at December 31, 2002 under the 1997 stock option plan.

	<u>Stock Options Outstanding</u>			<u>Stock Options Exercisable</u>	
	<u>Number of</u>	<u>Weighted Average</u>	<u>Weighted</u>	<u>Number of</u>	<u>Weighted</u>
<u>Range of Exercise Price</u>	<u>Shares</u>	<u>Contractual Life</u>	<u>Average</u>	<u>Shares</u>	<u>Average</u>
			<u>Exercise Price</u>		<u>Exercise Price</u>
\$1.65 - 2.31	475,224	1.2	\$1.82	475,224	\$1.82

below

A summary of the status of the 1998 stock incentive plan as of December 31, 2002, 2001 and 2000 is presented in the table

	December 31, 2002		December 31, 2001		December 31, 2000	
	Weighted	Exercise Price	Weighted	Exercise Price	Weighted	Exercise Price
Outstanding beginning of period	24,615,855	\$15.34	20,383,461	\$29.79	6,428,376	\$26.68
Granted	6,681,803	1.40	14,189,571	7.50	16,557,703	33.33
Exercised	(76,586)	0.12	(161,733)	11.17	(366,604)	11.47
Forfeited	(15,613,612)	11.77	(9,795,444)	34.14	(2,236,014)	50.07
Outstanding, end of period	15,607,460	12.72	24,615,855	15.34	20,383,461	29.79
Options exercisable at period-end	7,643,110		7,102,039		2,179,551	
Weighted average fair value of options granted	\$1.04		\$5.73		\$25.83	

The following table sets forth the exercise prices and weighted average remaining contractual life at December 31, 2002 under the 1998 stock incentive plan

Range of Exercise Prices		Stock Options Outstanding		Stock Options Exercisable	
Number of	Weighted Average	Weighted Average	Exercise Price	Number of	Exercise Price
Shares	Contractual Life	Average	Average	Shares	Average
1,843,061	5.5	\$0.65	638,171	\$0.63	
3,097,848	5.4	\$1.15	0		
288,286	5.2	\$2.08	0		
3,283,683	4.6	\$3.01	1,852,333	\$3.01	
591,820	4.2	\$5.90	234,685	\$5.79	
670,642	3.7	\$9.90	391,496	\$9.70	
3,066,671	3.4	\$14.29	2,354,487	\$14.36	
337,119	3.9	\$19.70	205,555	\$19.69	
1,226,391	2.9	\$38.54	987,895	\$37.88	
1,201,939	3.0	\$65.70	978,488	\$65.46	
15,607,460			7,643,110		

As the estimated fair market value of the Company's common stock (as implied by the initial public offering price) exceeded the exercise price of certain stock options granted during 1998 and 1997, the Company recognized deferred compensation of \$7,635 and \$2,031 at December 31, 1998 and 1997, respectively, of which \$423 and \$2,889 was amortized to expense during the years ended December 31, 2001 and 2000, respectively

In February 1999, the Company granted employee stock options under the 1998 stock incentive plan with an exercise price below market value at the date of grant. A deferred compensation charge of \$6,807 was recognized, and \$189, \$2,269 and \$2,269 was amortized to expense in the years ended December 31, 2002, 2001 and 2000, respectively

During 2000, the Company recognized a deferred compensation charge of \$957 as a result of an exchange of unvested stock options of acquired businesses (see Note 4) for employee stock options under the Company's 1998 stock incentive plan. \$313, \$313 and \$96 was amortized to expense in the years ended December 31, 2002, 2001 and 2000, respectively.

In November 2000, the Company granted non-qualified, outperform stock options to certain key employees under the 1998 stock incentive plan. These outperform options are notated as such due to the nature of the options in which the ultimate number and exercise price of the options are dependent on the performance of the Company's stock price relative to the performance of the NASDAQ 100 Index. As the number of options and the exercise price were not fixed at the date of grant, the Company accounts for these stock options using variable plan accounting under APB No. 25. This accounting will require the Company to measure and record compensation ratably from the date of grant until the options are exercised. The outperform stock options vest in equal quarterly amounts through November 2001 and generally expire on March 31, 2003. If the Company's exchange-traded stock price outperforms the NASDAQ 100 Index on a go-forward basis, it is possible that the Company could have material compensation charges in future periods related to unexercised outperform stock options. At December 31, 2000, the Company recorded a deferred compensation charge of \$12,128 and compensation expense of \$2,106 through that date. During 2001, this charge and all related expenses were reversed due to downward movement in the market price of the Company's common stock. No additional expense related to the outperform stock options was recognized during 2002.

During 2001 and 2002, the Company cancelled certain outstanding stock options, which caused grants made to the same employees within six months of these cancellations to be subject to variable plan accounting under APB No. 25. At December 31, 2002 and 2001, the deferred compensation charge related to these options was \$31 and \$5,288, respectively, and the Company had recorded compensation expense of \$22 and \$0, respectively through those dates. The deferred compensation charge will be amortized to expense over the vesting period of the stock options, and will continually be adjusted based on the market price of the Company's common stock.

During 2002, the Company issued 3,461,120 shares of restricted stock to certain management employees in exchange for stock options held by such employees that had an exercise price of five dollars and fifty cents or more at a ratio of three shares of restricted stock for every four shares issuable pursuant to such stock options. In addition, during 2002, the Company issued 2,920,000 shares of restricted stock to certain senior executives in exchange for stock options issued to such executives on October 15, 2001, at a ratio of four shares for every five shares issuable pursuant to such stock options. These restricted shares were issued at no cost to the employees, therefore, the Company recognized deferred compensation of \$6,509 based on the market value of the stock at the date of issuance. The deferred compensation charge will be amortized to expense over the three-year vesting period of the restricted stock. \$1,605 was amortized to expense in the year ended December 31, 2002.

Employee Stock Discount Purchase Plan. The Company's stock discount purchase plan is intended to give employees a convenient means of purchasing shares of the Company's common stock through payroll deductions. Each participating employee's contributions will be used to purchase shares for the employee's share account as promptly as practicable after each calendar quarter. The cost per share will be 85% of the lower of the closing price of the Company's common stock on the Nasdaq National Market on the first or the last day of the calendar quarter. The Company has 56,839 shares of common stock reserved for issuance under the stock purchase plan at December 31, 2002. During 2002 and 2001, 2,474,042 and 672,337 shares, respectively, were issued under the stock purchase plan for proceeds of \$3,887 and \$4,916, respectively. As of December 31, 2002, participants have contributed

\$32, which will be used to purchase the remaining 56,839 shares in January 2003. The Compensation Committee of the Board of Directors administers the stock purchase plan.

14. Long-Term Sales Contract:

Effective in 2000, and amended in 2000, 2001 and 2002, the Company executed a long-term contract to provide an integrated network solution and certain services to Genuity Solutions Inc., a network service provider and operator of a nationwide Internet network. The contract was established specifically to support Genuity's customer contracts, including that with America Online. This contract establishes Genuity as the Company's largest customer. Total revenues from Genuity for the years ended December 31, 2002, 2001 and 2000 were \$90,342, \$46,780 and \$22,274, respectively. The contract term expires on December 31, 2006. Under this agreement, Genuity committed to pay an aggregate of \$563.010 over the term of the contract, subject to the Company's performance under the contract and the other terms and conditions of the contract. The contract contains specific provisions that decrease Genuity's purchase commitment, including but not limited to, Genuity experiencing a business downturn. The agreement also provides that if the Company receives a going concern qualification or experiences an event of default as defined under the Credit Facilities, (a) Genuity may exercise an option to purchase all of the dedicated assets and infrastructure used by the Company to provide the integrated network solution to Genuity and (b) Genuity would still be required to continue to purchase certain services from the Company for the remainder of the term of the agreement. If Genuity exercises its option, Genuity would be required to pay (1) for the dedicated assets, the remaining undepreciated value of the dedicated assets and (2) for the certain services, the remaining overall value of the agreement less the amounts paid to purchase the dedicated assets and infrastructure.

On November 27, 2002, Genuity and Level 3 Communications announced that the two companies reached a definitive agreement in which Level 3 would acquire substantially all of Genuity's assets and operations and assume a significant portion of Genuity's existing long-term operating agreements. To facilitate the transaction, Genuity filed voluntary petitions for reorganization under Chapter 11 of the Bankruptcy Code. The consummation of Level 3's purchase of this Genuity contract was announced on February 4, 2003.

15. Quarterly Financial Data (Unaudited):

The following table summarizes results for each of the four quarters in the years ended December 31, 2002 and 2001.

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>Year</u>
Year ended December 31, 2002:					
Revenues	\$162,095	\$184,437	\$219,539	\$204,911	\$770,982
Gross profit	80,017	89,114	101,242	96,165	366,538
Net loss	(112,590)	(226,815)	(113,110)	(120,155)	(572,670)
Net loss per share, basic and diluted.	(0.97)	(1.94)	(0.97)	(1.00)	(4.88)
Year ended December 31, 2001:					
Revenues	\$105,874	\$124,059	\$135,137	\$151,818	\$516,888
Gross profit	54,646	63,258	69,423	77,827	265,154
Net loss	(96,340)	(103,338)	(106,537)	(125,598)	(431,813)
Net loss per share, basic and diluted	(0.87)	(0.92)	(0.94)	(1.09)	(3.82)